

CASE STUDY

SARONA FRONTIER MARKETS FUND 2 (SFMF2)

JUNE 2016

EXECUTIVE SUMMARY

Sarona Frontier Markets Fund 2 (SFMF2) is a USD 150M fund that invests in frontier and emerging market private equity funds, which in turn invest in small to midmarket companies. SFMF2 used a first-loss layer provided by the Canadian Government and a credit guarantee provided by the Overseas Private Investment Corporation (OPIC) to catalyze private investment in the fund. SFMF2 targets strong financial returns for investors and positive ethical, social, and environmental outcomes for investees. As of June 2016, SFMF2 had invested in funds that invest across 20 countries including Peru, Ecuador, Nigeria, Egypt, Vietnam, and Indonesia.

SFMF2's fund design and fundraising experience presents useful insights for others considering structuring or investing in blended funds, including:

- Concessional capital from public funders improves risk-adjusted returns and catalyzes private capital
- Determining the appropriate amount of concessional capital is currently more of an art than a science
- Many aid agencies lack appropriate internal policies, processes, and capacity to participate in blended finance investments
- To secure aid agency funding, it is important to build trust and identify internal champions

SYNOPSIS

Fund manager	Sarona Asset Management
Fund vintage	2013
Fund mandate	Fund of funds that invests in frontier and emerging market private equity funds, which in turn invest in small to midmarket companies; may also co-invest with investee funds in specific companies
Fund size	USD 150M
Anchor investors	OPIC, Government of Canada through Mennonite Economic Development Associates (MEDA)
Capital structure	USD 50M debt, USD 85M LP equity, USD 15M first-lost capital
Fees and fee structure	1% management fee, plus 10% performance fee after 10% preferred return to investors
Investment instruments	Equity
Investment size	Average investment size: USD 8M Minimum investment size: USD 1M Typical investee fund size: USD 70-300M
Fund term	12 years from final close with two optional one-year extensions
Target return	15% net IRR to LPs
Fundraising status	Closed
Impact metrics	Tracks 30+ Impact Reporting & Investment Standards (IRIS) metrics (e.g., job creation, gender equity, and environmental impact)

INTRODUCTION

Sarona Asset Management was established in 2010 after spinning out of Mennonite Economic Development Associates (MEDA), an international development organization. Sarona focuses on delivering capital to entrepreneurs in underserved markets with an aim to develop companies and communities profitably and sustainably. As part of MEDA, Sarona invested directly in companies in emerging markets. However, as private equity in emerging markets matured¹, Sarona became an independent firm investing in local investment funds that in turn invest in small and midmarket companies.

Sarona Frontier Markets Fund 1 (SFMF1) launched in 2010 as a proof-of-concept USD 30M fund of funds. After the first fund's experience, Sarona Frontier Markets Fund 2 (SFMF2) launched in 2013 to refine and scale the fund of funds approach.

FUND DESIGN AND FUNDRAISING

In early 2012, Sarona began developing SFMF2 with a target capitalization of USD 250M. Given its staff capacity and experience, Sarona undertook all fund design and fundraising internally. To augment initial funding from private investors (many of whom had also invested in SFMF1), Sarona responded to a call for proposals for impact investment funds from the Overseas Private Investment Corporation (OPIC), the U.S. government's development finance institution (DFI). Out of 88 applications, OPIC selected Sarona and five other funds.

OPIC as lender of record provided SFMF2 a credit facility of \$1 for every \$2 of equity capital raised by issuing certificates of participation (COPs) in the loan to the U.S. debt capital markets. The COPs are guaranteed by the full faith and credit of the U.S. government, and the COPs are priced competitively, which allows SFMF2 to borrow capital at a low interest rate to augment equity capital from private investors.

SFMF2 was a compelling investment proposition for OPIC for three key reasons: i) emphasis and measurement of social and environmental values and impact, ii) management experience investing in emerging and frontier markets, particularly with the SFMF1 track record, and iii) fund of funds approach, which enables OPIC to invest indirectly in smaller funds.

While in discussions with OPIC, SFMF2 continued to raise capital from private investors. However, fundraising was difficult and slow as many private investors demanded a higher risk-adjusted return than SFMF2 could offer. Because of this obstacle, as well as existing relationships, Sarona approached the Canadian government's aid agency, Department of Foreign Affairs, Trade, and Development (DFATD, now named Global Affairs Canada), to support SFMF2.

DFATD support came in the form of a CAD 20M contribution to MEDA, of which CAD 15M² flowed to SFMF2 as first-loss capital and CAD 5M was allocated to a separate technical assistance facility managed by MEDA. Given the unique nature of the investment, few benchmarks existed to determine the appropriate amount of first-loss capital. The partners eventually agreed to CAD 15M as the minimum level to enhance risk-adjusted returns enough to effectively fundraise from private investors. In addition to analysis and justification provided by Sarona management, DFATD based this figure on the maximum amount it could deploy to a single program.

SFMF2 was a compelling investment proposition for DFATD for three key reasons: i) ability to attract private investment through the use of catalytic capital, ii) emphasis on technical assistance, and iii) MEDA and Sarona's reputation and experience working in emerging and frontier markets. The main barrier DFATD faced in completing the investment was its lack of authority to accept reflows; there was no policy on how capital should be returned to DFATD in a situation in which all or a portion of the first-loss was not required. To overcome this obstacle, MEDA agreed to establish a special purpose account for reflows in which a decision on reflows will only be made at the end of the fund's life, with the expectation that DFATD will have specific policies on reflows by that time. Several "champions" within DFATD were critical in helping Sarona navigate these policies and the generally unfamiliar and complex environment to close the deal.

Capital from DFATD and OPIC invigorated SFMF2's fundraising process from private investors. Specifically, the DFATD first-loss capital mitigated risks for private investors by absorbing losses of principal invested in underlying funds and also improved returns; DFATD does not receive proportional returns, which improves overall risk-adjusted return for LPs. Sarona conducted a survey in which a majority of LPs commented that risk-protection was an important factor in their decision to invest, and some would have not invested without risk-protection. The OPIC commitment did not play a risk-reducing role because it was senior to the LP capital, but it did improve expected returns

¹ According to the Emerging Market Private Equity Association (EMPEA), more than 1,000 emerging market based fund managers exist today.

² At the time of this contribution, CAD 15M was equivalent to USD 15M.

due to its low cost and minimal upside sharing. The OPIC commitment also sent a strong signal of investment viability.

SFMF2's fund design and fundraising process took approximately one-and-a-half years from launch in early 2012 to first close in the middle of 2013. While the process of securing public capital was lengthy, it increased the speed of fundraising once secured.

FUND STRUCTURE AND GOVERNANCE

CAPITAL STRUCTURE

SFMF2 reached a final close at USD 150M, capitalized by private, public, and philanthropic investors. The capital structure of SFMF2 is as follows:

- **Debt, USD 50M:** The most senior layer in the fund, OPIC is the lender of record and provides its funding through COPs in the loan, guaranteed by OPIC, which are sold in the U.S. capital markets and priced competitively. OPIC's participation is limited to \$1 for every \$2 of equity capital in SFMF2.
- **LP equity, USD 85M:** The senior equity layer in the fund, invested by individuals, corporations, foundations, non-profits, pension funds, and endowments.
- **First-loss capital, USD 15M:** The junior equity layer, contributed by DFATD through MEDA. The layer is charged organizational costs, management fees, and fund expenses in proportion to other investors, but does not accrue gains or profits.

Capital is returned to investors in a waterfall structure, as follows:

- Debt principal plus interest is paid to creditors and LP equity capital is returned to investors, *pari passu*
- First-loss capital, minus fees, expenses and losses, if any, is only returned when all capital has been returned from underlying investments

SFMF2 has a target net IRR for LPs of 15%, which compares favourably to the market. According to Cambridge Associates, 2012 vintage emerging market private equity and venture capital funds have a median net IRR since inception of 8.8% and an upper quartile net IRR of 19.33%. Further, 10-year pooled net IRR for Cambridge Associates' Emerging Markets Private Equity & Venture Capital Index is 11.40%.

TECHNICAL ASSISTANCE

SFMF2 is associated with a unique technical assistance facility. Of DFATD's CAD 20M grant, 5M was allocated to a technical assistance facility with two programs:

- Sustainable Innovation Grant Fund managed by MEDA
- Global Fund Manager Mentorship Program managed by the MaRS Centre for Impact Investing

Through the Sustainable Innovation Grant Fund, companies apply for matching grants of up to CAD 80,000³ to improve the sustainability of their operations, with a specific focus on environmental, social, and governance policies and practices. This funding is available to any companies, including but not limited to those that received funding from underlying SFMF2 portfolio funds.

The Global Fund Manager Mentorship Program matches experienced North American private equity managers as mentors to private equity managers in emerging markets to enhance their management skills and help them become more successful in attracting private investment. The program is only accessible for fund managers that SFMF2 considered, but ultimately did not fund.

Traditional technical assistance facilities provide grant-based support to fund investments that build capacity within the fund's portfolio. The SFMF2-associated technical assistance facility, however, differs from most by making its grants accessible to any company and ensuring its mentorship program pairs mentors with fund managers that SFMF2 did not invest in.

LEGAL STRUCTURE AND GOVERNANCE

SFMF2 has three legal structures to accommodate investors from different jurisdictions and investors with different tax requirements:

- Sarona Frontier Markets Fund 2 LP is the master fund, a Cayman Islands exempted limited partnership.
- Sarona Frontier Markets International Fund 2 LP is the international feeder fund, a Cayman Islands exempted limited partnership. This feeder fund caters to non-US investors, and US tax-exempt investors such as OPIC and pension funds.
- Sarona Frontier Markets US Fund 2 LP is the US feeder fund, a Delaware limited partnership. This feeder fund caters to taxable US investors.

Regarding governance, Sarona General Partner 3 Inc. (SGP3 Inc.) is the governing entity of SFMF2. SGP3 Inc. sub-contracts Sarona Asset Management to carry out daily activities for SFMF2 and an investment committee reviews

³ CAD \$160,000 counterpart contribution required by the company.

and recommends investments. Ultimately, all investments require SGP3 Inc. approval.

FUND OPERATIONS

INVESTMENT CRITERIA

SFMF2 seeks fund managers that meet the following requirements:

- Based in emerging or frontier markets
- Invest in small to mid-market companies; not in real estate, extractives, or infrastructure
- Focus on social and environmental values
- Strong financial track record

SFMF2 aims to invest in 12-18 private equity funds, which will in turn invest in 120-150 companies in over 30 countries. Investment periods span 3-6 years from first closing, with capital calls as commitments are funded. The minimum investment size is USD 1M.

INVESTMENT PROCESS

SFMF2 follows a three-step process for identifying, evaluating, and executing investments:

- **Screening:** SFMF2 sources opportunities from networks, partners, conferences, and databases. For example, Sarona has created a proprietary database of over 1,000 frontier and emerging market private equity fund managers. SFMF2 then assesses fund managers against investment criteria.
- **Due diligence:** For fund managers who meet criteria, SFMF2 conducts quantitative and qualitative analysis, as well as desk and on-site due diligence that consists of introductory meetings followed by in-country diligence.
- **Negotiating and closing:** The final step in the investment process is negotiation of terms and information and economic rights.

INVESTMENT ACTIVITY TO-DATE

As of June 2016, SFMF2 has drawn down USD 80M (comprising USD 40M debt and USD 40M LP capital), which has been invested in funds investing across 20 countries including Peru, Ecuador, Nigeria, Egypt, Vietnam, and Indonesia. Investee funds generally range in total size from USD 70M to USD 300M. SFMF2's average investment size is USD 8M. Examples of specific SFMF2 investments are included in Figures 1 and 2 below.

VEROD CAPITAL FUND II

SFMF2 commitment: USD 7.5M

Fund size: USD 115M

Fund country focus: Nigeria

Fund investment focus: Companies producing products that are typically imported (e.g., fruit juice)

Expected impact: Play a role in shifting Nigerian economy's reliance away from oil production

Figure 1: Verod Capital Fund II

KANDEO FUND II

SFMF2 commitment: USD 5M

Fund size: USD 250M

Fund country focus: Colombia, Peru, Mexico

Fund investment focus: Financial inclusion for the unbanked and financial instruments to enhance SME success

Expected impact: Management team has embraced impact values and seeks to transform each company to achieve ever-improved social and environmental outcomes

Figure 2: Kandeo Fund II

IMPACT METRICS

Sarona believes that applying ethical, social and environmental values to each investment decision builds a better world for current and future generations, as well as helps generate strong financial returns. By focusing on these values, and the achievement of the Sustainable Development Goals (SDGs), Sarona seeks to change the way businesses are run.

SFMF2 tracks over 30 Impact Reporting & Investment Standards (IRIS) metrics, including job creation, gender equity, and environmental impact. The fund also tracks its investee companies to the SDGs. SFMF2 requires all investee fund managers to undergo a Global Impact Investing Rating System (GIIRS) Fund Manager Assessment prior to investment, and investee funds must also report on performance of portfolio companies annually. In addition, Sarona creates an annual values report.

Investee funds deploy capital across a variety of sectors, including healthcare, education, financial services, ICT, consumer goods and services. SFMF2 seeks impact through all investments, either through a company's inherently impactful products (such as healthcare), or through the way

in which a company improves the social and environmental outcomes of its operations.

FOLLOW-ON FUND

As a result of the early success of SFMF2, Saroná is in the process of fundraising for Saroná Frontier Markets Fund 3 (SFMF3). SFMF3 has a target size of USD 300M, with a capital structure of USD 100M debt (credit guarantee already approved by OPIC), USD 30M first-loss capital (currently being sought), and USD 170M LP equity (currently being raised). This target capital structure maintains the same proportion of debt, first-loss capital, and LP equity as SFMF2.

KEY INSIGHTS

SFMF2's fund design and fundraising experience presents several insights useful to others looking to create and/or invest in similar blended vehicles:

- **Concessional or low-cost capital from public funders improves risk-adjusted returns and catalyzes private capital:** Before the first-loss layer from DFATD was in place, fundraising for SFMF2 was difficult and slow as many private investors demanded a higher risk-adjusted return than SFMF2 could project. Once the first-loss layer was in place, the fundraising process accelerated. In Saroná's survey, a majority of LPs commented that risk-protection was an important factor in their decision to invest, and some would have not invested without risk protection. Further, the OPIC-supported leverage improved expected returns because of its low cost and minimal upside sharing.
- **Determining the appropriate amount of concessional capital remains more of an art than a science:** There is still little evidence around blended finance structures and the appropriate amount of concessional capital required to catalyze private capital. The amount of concessional capital is often driven by donor preferences and the maximum amount of capital they can deploy to a single program.
- **The question of whether aid agencies should incorporate appropriate structures and authorities for blended finance, or whether grant authority and budgets should be given to DFIs, remains outstanding.** Aid agencies mostly deploy grants and many are not equipped with the structures, authorities, and capacity to deploy investment capital, unlike DFIs, which are designed to provide investment capital and have clear and transparent processes for doing so.

- **To secure aid agency funding, it is important to build trust, align incentives, and identify internal champions:** Blended finance as an approach tends to be controversial in the public sector, as many worry about the private sector profiting from aid agency capital. Because blended finance involves many stakeholders with divergent values and objectives, trust among partners is critical. To be successful, each party must believe that the other partner respects its goals, is committed to achieving them, and can credibly and efficiently do so. Further, identifying a champion to navigate complex public sector environments is key to securing funding.

SOURCES

Interviews with Saroná management, DFATD, OPIC, and private investors.

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ABOUT CONVERGENCE

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INVESTMENT NETWORK: An online platform where investors can connect and co-invest in deals in emerging and frontier markets

MARKET BUILDING TOOLS: Knowledge resources to help investors improve their blended finance understanding and capabilities

DESIGN FUNDING: Grant funding for practitioners to design innovative financial instruments that would otherwise be too risky or complex to pursue

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